TRADING IS NOT GAMBLING

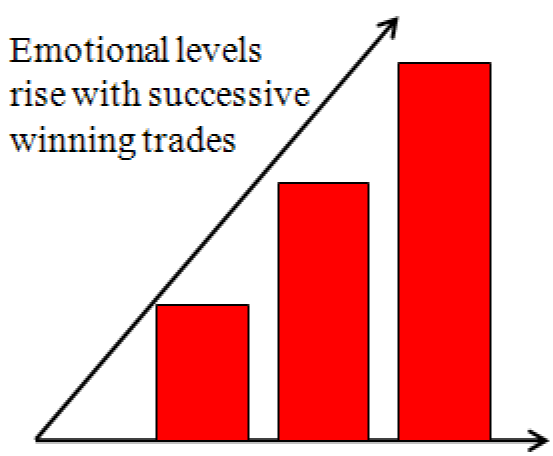
By P Doggett

A gambling event is when the beginning and the end of the vent are set by a third party. Think of a game of cards that starts when the dealer says so, and stops when the cards are all distributed. A gambling event is when you lose all of your stake. If you lose a hand of cards, you lose all of your bet.

The market is different. You decide when you buy and when you sell. You decide how much you are prepared to lose – a small amount or a large amount. Many people use the market for gambling but this doesn't mean the market is a gamble.

If a gamble that you make pays off, you are more likely to feel greater motivation to immediately take another gamble rather than walk away from another opportunity to take a similar gamble. After two or three winning gambles in a row, many people feel as though they are on a 'hot streak' and won't let any opportunity pass them by. Alternatively they feel immediate exhilaration and satisfaction of the pay off and are more likely seek out similar gratification as soon as possible. These are the sorts of emotional drivers that provide the motivation for gambles.

Similar emotional drivers affect traders. For example, when traders make a profit, they are more likely to get back into the market much faster than if they had recently suffered a loss. Unfortunately the mental euphoria of making a profit may impede a traders' ability to make good decisions which could lead to a poor follow-up trade based on inadequate analysis and with no safe guard in place, such as a stop-loss.



On the flip side, we also know that while profits are motivating to re-enter the market, losses can be equally de-motivating and often cause traders to stay out of the market. Bad losses can cloud a trader's judgment which means that he or she may not take the next trade which fits all their preferred criteria. They may be nervous about their ability to trade or to analyse the market or simply nervous about losing any more money. When we feel like this and we side step taking the next trade, we often feel glad that we didn't put ourselves under pressure by having another open trade. But when that trade turns out to be a winning trade we often feel bitter and annoyed that we had in fact, been so nervous and de-motivated to take the trade.

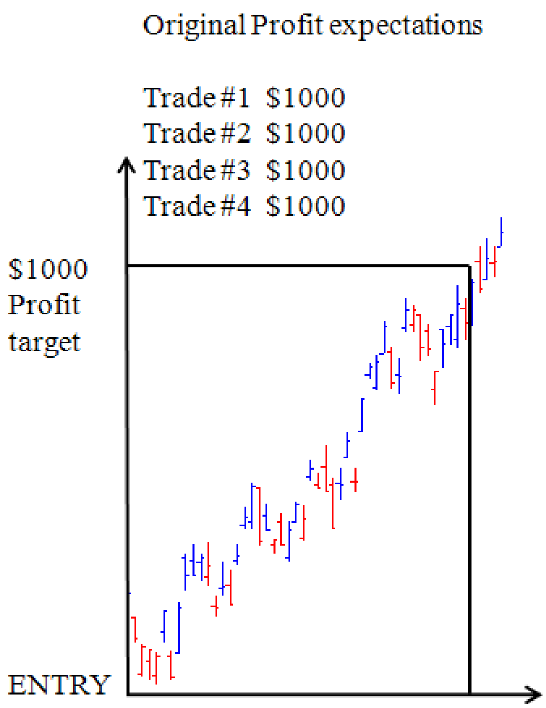
In one of the most interesting experiments on the motivation to continue gambling or to quit, researchers Rivers and Arvai divided their participants into three groups. Unbeknown to the groups, Rivers and Arvai had already decided to rig the experiment so that the first group were destined to suffer "chronic" financial losses. The second group was rigged so that they would experience only winning gambles and the final group were going to be exposed to random outcomes. The researchers found that:

> "Subjects exposed to chronic losses also displayed a depressed affective state and a tendency to accept less as an outcome of future decisions, and still consider it to be a satisfactory result."

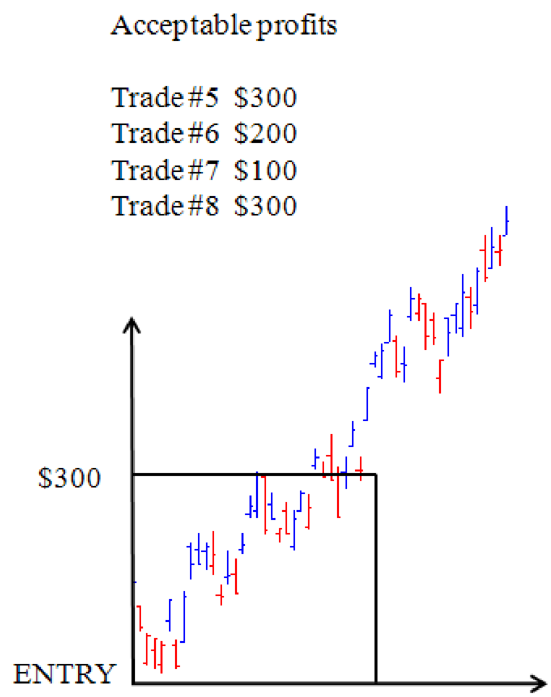
We can draw parallels between this finding and what happens to traders as a result of the wins and losses they encounter in the market. For example, traders who suffer a string of losses are often prone to suddenly being very satisfied with much lower profits than those they had previously been chasing.

Profit expectations	Losses experienced	Acceptable profits
Trade#1 $1000	Trade#1 $ - 500	Trade#5 $300
Trade#2 $1000	Trade#2 $ - 500	Trade#6 $200
Trade#3 $1000	Trade#3 $ - 1000	Trade#7 $100
Trade#4 $1000	Trade#4 $ - 1500	Trade#8 $300

Traders may become conditioned to accept less profit and often take early profits rather than face suffering another loss. This phenomenon may help to explain the disposition effect, where traders sell winners and hold onto losing positions. We will look at the disposition effect in another article.



Trader enters the market with expectations of high profits



Trader takes small profit out of a fear of letting open profits becoming losses

It is a mental tug of war between taking each loss in the market personally versus being able to treat each and every trade as an individual event – unrelated to the next profit or loss. This is difficult for most people to do because they do have an emotional involvement in their trades and they do take profits and losses personally and as a consequence, they become influenced and motivated by past actions and experiences.

So how do we combat this affect? First we have to recognize the symptoms. The first one to be wary of is taking a series of small wins after a series of losses and feeling satisfied with these small wins. It is the first tell tale sign that we are being motivated to act in the market by our memory and emotions rather than by a legitimate sell signal in the market.

The second symptom to be wary of is equating personal performance with profits. For example, we may get back into the market too quickly after a string of winners because our judgement and ability to analyse trades is clouded by a desire to build up our ego rather than by anything else. Also, we need to stop equating personal performance with profits because when we do this after a string of losses, we typically become more obsessed with defending our ego by taking a string of small (and early) profits, rather than being focussed on trading the trend or chart pattern to its full extent.

Thirdly, we have to treat each trade as a stand alone event, unrelated to past performance. Each trade lives or dies by the outcome of the market and should remain uninfluenced by our memories and emotions.

Finally, we may have to do a bit of soul searching and uncover another motivation to trade rather than seeking short term gratification of the thrill of trading itself. A desire to trade on ego or to improve on past performance is not the right sort of motivation. Your focus should be on accurately defining profit potential and accurately assessing risk, then taking the trade within these parameters, rather than within the parameters of your memory of past performances.

Expectancy tells you the net profit or loss that you can expect over a large number of single unit trades. Expectancy is = (probability of winning x average win) – (probability of losing x average loss)

Expectancy and probability of winning are not the same thing. People have a bias to want to be right on every trade or investment. As a result, they tend to gravitate towards high probability entry systems. Yet quite often these systems are also associated with large losses and lead to negative expectancy. As a result, always take your risk in the direction of the expectancy of your System. The impact of expectancy is discussed in *Dr Van Tharp called* ***Trade Your Way To Financial Freedom. Trade Your Way To Financial Freedom by*** *Dr Van Tharp.*